ISLAMIC DEVELOPMENT BANK
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# ISLAMIC EQUITY FUNDS
## THE MODE OF RESOURCE MOBILIZATION AND PLACEMENT

by

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# INTRODUCTION

## 1. BACKGROUND OF THE SUBJECT

The use of mutual funds as financial products in general increased tremendously during the last three decades as there has been a greater awareness of the benefit of diversified portfolio under full-time professional management with the safeguard of trustee supervision and statutory control.

This investment vehicle normally suits all categories of investors in the medium-and-long-term. The principal concept of mutual funds is that risks and rewards are shared by investors. Thus, mutual funds are essentially investment tools. The argument in favor of mutual funds compared to other types of investments are powerful such as: funds provide a level of diversification by industry; investors achieve diversification by company.

There are different types of mutual funds such as: closed and open-ended funds, low and high risk funds, income and growth funds. In general, open-ended funds are known as mutual funds (Al-gari, M. Ali, 1998, p. 5). In addition to this, mutual funds work in different sectors so that there are commodity funds, leasing funds and equity funds.

This study is on equity funds and addresses a central question that: can equity funds be worked on Islamic principles? This notion has been approached in three dimensions: first, to be pursuant to Islamic rulings, equity funds must not transact in equities of companies which produce or trade in prohibited goods; second, equity funds run on Islamic basis must get rid of interest income generated through interest-based lending; third, Islamic equity funds should not .trade in stocks of companies which have higher gearing ratio, i.e., their assets are basically in the form of cash and debts.

Therefore, these are the issues which need to be clarified and resolved with the view to implement the notion of equity funds in an Islamic perspective.

## 2. IMPORTANCE OF THE STUDY

Launching Islamic equity funds thus requires clearance of the *Shari* 'ah-related matters. Other operational aspects such as the relationship between

investors and management, portfolio diversification and portfolio distribution with regard to industry and countries must be investigated.

## 3. THE STUDY ASSUMPTION

The basic assumption is that theory and practice of the traditional equity funds can be evolved according to Islamic principles. Therefore, setting-up of Islamic equity funds is possible and prospective.

## 4. METHODOLOGY AND STRUCTURE

The study depended on the secondary data available on the Islamic equity funds. It also depended on disperse literature on this new field.

## 5. STRUCTURE OF THE STUDY

Section I is on principles governing workings of Islamic equity funds and their implementation;

Section II on procedures and policies of Islamic equity funds in light of Islamic principles regulating their work;

Section III concentrates assessing performance of Islamic equity funds; and

Section IV is the conclusion.

# PRINCIPLES OF ISLAMIC EQUITY FUNDS

The subject related to Islamic Equity Funds (IEFs) is yet an emerging field. Its shape is still in transition specially with respect to Islamic principles that govern their operation. Of many issues in this connection, the most significant are: (i) area of activity for companies whose shares are the target for IEFs; (ii) the interest element in companies income; (iii) the debt equity ratio of companies. Here is a discussion of these issues in two stages via: (a) fiqh-based guidelines regulating works of IEFs in practice, and (b) an assessment of these guidelines in light of the recent fiqh view.

## 1.1 Guidelines regulating works of IEFs

The first part of this section is an overview of the mechanism whereby IEFs deal in stocks of companies without, however, contravening *Shari 'ah* boundaries. The second part , that follows would be an assessment of this mechanism vis-a-vis the *current fiqh* perspective.

### I. Business activity of shareholding companies

In order to trade in shares of companies, IEFs must be certain about permissibility of the product of such companies. The ideal situation is trading in shares of companies whose activities are permissible and in accordance with *Shari 'ah* requirements. But some companies undertake such prohibited businesses or mix them with permissible ones. In brief, the *fiqh* opinion is that: if objectives of the company are legally consistent with *Shari 'ah* rules, then its business is accept Exhibit and Muslim investors could buy shares of this company, (The Islamic *figh* Academy, 1992). This is the principle.

In practice, so far it is easy to screen companies in this regard and sort out the permissible and non-permissible businesses. Those who are in charge of IEFs now have regular checking of these things through their investment advisors. Investment advisors are usually given' instructions to avoid investment in shares which are backed-up by any of the prohibited goods or services. More practices have increased the ability of IEFs in this regard to the degree that periodical checking becomes very frequent, on monthly basis.

According to Dow Jones. Islamic market Index (1998), all IEFs undertake screening of non-permissible industries to avoid investment in stocks which are backed by prohibited goods/services..

## II. **The interest as a component in companies' revenues**

This matter is pretty delicate and more difficult to manage. IEFs now have the technique of exploring companies with the view to deal in shares of companies whose objectives and areas of activity are allowed in the *Shari'ah* rulings. But these reviewed companies borrow and lend frequently on interest basis. IEFs are then encountered with a critical question that: do they - in principle — transact in stocks of such companies whose businesses are pursuant to Islamic principles but undertake interest-based borrowing and lending?

This issue has been addressed before. Strict compliance with the *fiqh* conditions requires that interest should play no part in the affairs of a company. One of the *fiqh* views in relation to dealing in shares of this type of companies is that of the Islamic *Fiqh* Academy which says in this concern: (i) as long as business as such is legitimate in principle, setting a shareholding company with accept Exhibit objectives and activities is consistent with *Shari'ah* rules; (ii) *fiqh* scholars unanimously agree on prohibition of participating in companies whose basic objective is prohibited like dealing in *riba* or producing and/or trading in prohibited goods and services; (iii) the *fiqh* principle is prohibition of buying shares of companies that frequently deal in prohibited things such as *riba* although its basic activities are prohibited, (The Islamic *Fiqh* Academy Journal, Vol. 7, pp.712-13).

IEFs differ in parameters applied to controlling the interest element in incomes of companies. The parameters range between 10% and 5% so that companies whose interest income/total income ratios within this range could be a target for trading in their shares.

To purify the return to unit investment holders, IEFs figure out income from interest-based investments and deduct this percentage and use it for humanitarian and charity purposes.

## III. The debt-equity ratio of companies

Balance sheets of some companies contain a disproportionately big percentage of debts compared to the shareholders' equity. The problem with shares of such companies is that sale of debt, or in this case in particular sale/purchase of shares backed by debt and/cash is regulated by the special *fiqh* rulings in connection with debt and cash – the *sarf.*

The Islamic *Fiqh* Academy decides on this matter and the formal legal opinion of the Academy is, that if the dominant shareholders' equity is mainly

in the form of real assets and usufructs[1], then such shares could be negotiated. If, instead, debts dominate, *fiqh* rulings pertaining to debt must be applied, (The Islamic *Fiqh* Academy Journal, 1990 and 1992)[2].

Companies by far depend on interest-based borrowing to increase their financing capacity. Now, how can the emerging IEFs take a position in stock markets since this is a real existing position? In this connection, those in charge of these funds developed some concepts on the maximum debt-equity ratio. This widely-accepted maximum ratio is one-third. Dow Jones Islamic Market Index (1998) reveals that all IEFs exercise leverage screening on companies to identify the 33% debt/equity ratio. Further, Dow Jones Islamic Market Index revealed (in 1998) that the loan-plus-cash/assets ratio for all IEFs was 50% or less.

These are the main features of IEFs in relation to *fiqh* guidelines binding them. Managers of these funds evolved these indicators in cooperation with their *fiqh* advisors and through inquiries referred to some figh authorities.

As a matter of fact, such guidelines prompted heated debate and discussion. Muslim jurists paid efforts to clarify *fiqh* foundation of these guidelines and whereas some of the jurists accept them others loudly declare their opposition to such a compromise. Hence, what is the strength of these guidelines vis-a-vis *the fiqh* rulings? Second part of this section adheres to this point.

### 1.2 Transacting stocks of shareholding companies – *fiqh* view

Trading of stocks of shareholding companies has been explored in *fiqh* perspective by focussing on permissibility and non-permissibility of participating in stocks of companies which commit interest-based deals on *frequent* basis provided their activities are permissible.

The resultant *fiqh* opinion in this concern is expressed by two main schools of *fiqh* thought:, the. first sees prohibition while the second adopts permissibility with restriction. Opinions expressed by the first school are corporate as well as individual opinions. The corporate *fiqh* opinions are basically those of the Islamic Academy and other circles that showed interest in

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[1] Dominance of real assets and usufructs implies that they represent more than 50% of the total equity.

[2] For detailed *fiqh* analysis on sale of debt, see: (1) Hammad, N. Kamal (1990), *Studies in Principles of Debts in Islamic Fiqh;* (2) Hammad, N. Kamal (1986), *Bai Al Kali ' Bi Al Kali '.*

the issue. Here is an overview of these corporate views followed by individual opinions.

**I. Corporate fiqh view disallowing subscription**

a) The Islamic *Fiqh* Academy (IFA) issues recommendation in relation to participation of the Islamic Development Bank in companies (December – 1990) saying that: the IDB should not subscribe in any company that does not avoid *riba* (interest) even if its activities are compliant to *Shari 'ah* rules (Journal of Islamic *Fiqh* Academy, vol. VII, part I, p.535).

b) The IFA recommendation issued in November 1991 which is of four parts. The third one says `in principle, subscription in companies that occasionally deal in *riba* is prohibited'. The fourth part of this recommendation says `those who subscribe in such type of companies with the intention of converting their prohibited activities into *Shari* 'ah-compliant ones may do so *if they are able* to introduce change upon entering these companies (ibid, p.541).

c) The IFA decision issued in May 1992 which is of three parts, part one is identical to the recommendation referred to in (2) above.

d) In 1993, the IFA addressed the matter for the fourth time and reconfirms prohibition of subscribing in companies that occasionally deal in *riba.* The IFA adds some qualifications that it is permissible to subscribe in such companies *with the intention* to transform their activities to be in line with *Shari'ah* requirements as soon as possible (Journal of Islamic *Fiqh Academy,* vol. VIII, part III, p.783).

**II. Individual fiqh view disallowing subscription**

(a) Bin Baya maintains strict *fiqh* view against subscription in companies which deal in *riba.* He divides these companies into three types: (i) those which declare their involvement in prohibited activities, (ii) those whose rules do not declare this but are well-known in practicing prohibited activities including *riba*, and (iii) companies which are managed and controlled by non-believers who do not care very much to avoid prohibited activities (Journal of Islamic *Fiqh* Academy, vol. VII).

b) Bin Baya believes that participation in the first two types of companies is prohibited. Regarding the third type, he believes that if a Muslim subscriber partly manages the company and able to prevent *riba,* than he could be a subscriber. If not, in this case it is not allowed to participate.

b) Commenting on Bin Baya's view, Al-Dareer agrees with this *fiqh* view especially with respect to management of the joint venture by the partner - who might be a non-believer, a Jewish or a Christian – in absence of the Muslim partner, (Al-Dareer, 1998, p.21). Al-Dareer says partnership involves delegation and agency, and every partner is an agent to his counter-partner. Thus, subscribing in companies that occasionally deal in *riba* transactions is delegating and extending authorities to the partner to deal in *riba.*

c) Al-Saloos adopts a much stringent *fiqh* view towards subscribing in companies that practice *riba* deals on frequent basis. He asserts that the shareholding company must be an Islamic company with *Shari 'ah* supervisory board to vet its activities with the view to be compliant with *Shari 'ah* principles. He says that shareholders in the first place and executive managers are all account Exhibit and responsible for sinful transactions, if any. Therefore, subscription in these companies implies responsibility of these usurious practices (Journal of Islamic *Fiqh* Academy, vol. VII).

d) Al-Saloos rejects the argument tat since the majority of business of such. companies is not against *Shari 'ah* rules, then the small portion of prohibited business is like the *Shari*'ahi-compliant activities. He alleges that whether it is small or large, any usurious transaction is prohibited. In addition, he believes that netting the return on shares of these companies by deducting usurious component is not enough and should not make interest-based transactions acceptable. The one who deals in usurious transactions, he says, should give up immediately and repent instantly of what he had done.

(f) Al-Zarqa differentiates between those companies whose business activities are of commercial nature such as companies which manage hotels, and those which provide necessary services such as power and water supply. To him, subscription in the first type is prohibited whereas it is allowed in the second type even if these companies

commit usurious businesses frequently (Journal of Islamic *Fiqh* Academy, vol. VII).

(g) Along the same line of argument, several individual Muslim scholars prohibited subscription in companies that occasionally undertake *riba* transactions. Among these scholars is Al-Marzouqi who says there is no necessity for subscribing in these companies. He alleges that exceptional types of transactions in *fiqh* (such as sale of *al-araya* as an example) have been ruled by special *fiqh* rulings pertaining and peculiar to these cases. Therefore, there is no room for *qiyas* (analogy) against the background of these exceptional rules. Al-Marzouqi says the case of subscribing in these companies is not an exceptional case and there is no room to measure it against the known exceptional *fiqh* views (Journal of Islamic *Fiqh* Academy, vol. VII).

**III. Fiqh view allowing subscription**

(a) Among those who advocate participation in shareholding companies is Al-Qaradaqi who suggests some qualifications for subscription as follows: (a) the subscriber's intention is to change the company's activities towards permissible activities; (b) subscription would be under necessity conditions; (c) a subscriber must purify the income received by deducting the estimated interest component (Journal of Islamic *Fiqh* Academy, vol. VII, 1992).

(b) Abu Ghuddah follows line of argument similar to that of Al Qaradaqi. He says `if the company's article of association clearly states dealings in prohibited objects, or if the company undertakes usurious businesses through its subsidiary(ies), then a Muslim is not allowed to subscribe in this company. He suggests that if the company does not practice unlawful activities then a Muslim investor could buy its shares and supervises its business so that the subscriber would withdraw timely when he realizes existence of these unlawful practices (Journal of Islamic *Fiqh* Academy, vol. IX, part II, 1992).

(c) Al-Mani' proposes three conditions for subscriptions via: (a) management control must not be with the non-believer especially if the Muslim entrant is not capable or unable to change financial and investment policies towards *Shari* 'ah-compliant businesses;
(b) the company's article of association should not include any

item that gives right to the management to borrow or lend on interest basis; (c) subscription must be a consequence resulting from necessity, (Al-Mani', Abduallah, 1998).

### 1.3. Main findings of *fiqh* view

So far, these are the key *fiqh* views with respect to subscribing, buying and selling shares of companies that *frequently* undertake businesses on interest basis. The main finding that comes up out of these opinions may be that they prohibit subscription and express this prohibition in different ways and for different reasons as follows:

(a) if the Muslim subscriber is unable or unwilling to change usurious activities;

(b) if business is overwhelmingly controlled by non-believers (or the Jews or Christians who do not observe any religious banning of *riba),* in the absence of Muslim partner or in case of inability of the
latter to eliminate usurious practices;

(c) if the company business is of a commercial nature rather than strategic business that the society would need.

Al-Dareer discusses these views and comes to the conclusion that with respect to subscription in companies which *on-and-off incur usurious practices,* Muslim investors should observe and must stick to the decision of the Islamic *Fiqh* Academy that has been taken in the seventh general meeting. This decision, referred to earlier, prohibits subscription in these companies[3]

Further, Al-Dareer suggests that subscription in such companies may be allowed if their businesses are under control of Muslims who are capable of introducing immediate change in course of the business in line with *Shari 'ah* requirements (Al-Dareer, Siddiq M. Al-Amin, 1998).

If, however; this is the *fiqh* view, it is obvious that the authorities as well as individual Muslim jurists have reservations on trading in stocks of companies that from time to time undertake interest-based practices although their objectives as well as the majority of their other businesses are accepExhibit in the Islamic context. Even the *fiqh* views which defend trading these stocks qualify permissibility with several restraints to the degree that it

3 See: Journal of the Islamic *Fiqh* Academy, vol. VII, part I, p.711. 

might be difficult to meet these conditions with the view to buy and sell shares of these companies.

Now, looking at guidelines governing operations of IEFs in relation to these *fiqh* views, it becomes obvious that those who launched and run these IEFs take the *fiqh* opinion which allows trading equities of companies that occasionally incur usurious transactions.

Of course, the way IEFs have been dealing in stocks is being under attack from some of the prominent *fiqh* jurists. For instance, one of the guidelines that govern operations of IEFs is that: the percentage of prohibited activities of any company should not exceed 10 (percent) of the whole business activities of the company, and the percentage of debt to total value of assets must not exceed one-third.

These ratios have been developed by managers of IEFs in consultation with their *Shari 'ah* advisers. The *fiqh* foundation for this are two famous *fiqh* principles, namely: (i) the minor part would be ruled and judged by the overriding part, and (ii) what could be accepExhibitas a dependent may not be permitted as an independent. Al-Dareer discusses application of these two *fiqh* principles on the case of IEFs. He indicates the following:

Use of the first principle is irrelevant in this case in particular because the question here is about <u>subscribing</u> in companies that sometimes involve in usurious transactions. Subscribing in the company is totally different from <u>dealing</u> with the company. Subscription means buying shares of the company whereas dealing involves buying commodities/services from the company or selling commodities/services to the company.

Similarly, application of the second *fiqh* principle is irrelevant because there is no `dependent' and `independent' in case of subscribing in these companies. No body would say that the small portion of prohibited activities is dependent while the big portion of allowed businesses is independent and hence the former would be accepExhibitas a dependent to the total. Al-Dareer says `upon subscription the shareholder becomes a partner in the company and one of its owners. If the company lends one dollar on interest basis and the shareholder has his share in this interest he commits *riba',* (Al-Dareer, 1998, pp.51-52).

It seems that there is no unanimous agreements among *fiqh* jurists regarding trading in stocks of shareholding companies which are the target for IEFs. Not only that, *fiqh* views upon which guidelines regulating workings of

the IEFs have been attacked by irrelevantly *applying fiqh* principles to case of trading in these stocks.

Hammad made a review of the *fiqh* opinions opposing subscription in those types of companies whose objectives and business are accepExhibit in *Shari 'ah* but undertakes these usurious borrowing/lending transactions. This *fiqh* school, he says, builds its opposition position upon background of the following:

a) that *quranic* verses unequivocally prohibit *riba.* Thus, contracts involves *riba* are invalid whether *riba* is in small percentage or large percentage, obvious or hidden, and whether it is pure *riba* or mixed with other permissible businesses!

b) Subscribing in shareholding companies owned and managed by non-Muslims is prohibited as the Prophet prohibits partnership with the Jew or the Christian unless sale and purchase is in the hands of the Muslim partner;

*c)* *Shari 'ah* rules are more concerned about the prohibited practices than the ordered practices. The Prophet is reported saying `do what I order you to do to the best of your capability and avoid what I prohibit'.

d) The prohibited part of the company's capital causes prohibition to the whole as the prohibited part spreads and becomes inseparable. The shareholder would definitely be unable to assess and eliminate prohibited part as the whole is mixed. The shareholder sells his shares which represents a whole package**.** In *fiqh* principles, if the permissible and the prohibited things are together, then the prohibited will *override.*

e) Dealing in shares of these companies involves at least suspicion of the prohibited practices because of the mixture of accepted with disallowed income.

f) Purification of the prohibited part of return and spending it in charity and humanitarian aspect of spending does not introduce permissibility to this transaction. This netting does not stand as repentance from taking *riba.*

(g) Further**,** netting depends on estimation which is certainly not the exact amount of interest paid as return to the share. It is extremely

difficult for the Muslim investor to assess this amount because interest element increases over time and the financial and investment affairs are all handled by the non-believer.

(h) Assessment of the interest element is at the end of financial year when accounts closed, but trading on shares is a continuous process undertaken on frequently shorter time.

(i) Subject of the contract under consideration is prohibited as it contains *riba.* As such, the contract itself is nullified.

(j) Use of *qiyas will* reveal that dealing in these stocks which involve obvious *riba is* decidedly prohibited because here *riba is* by all means committed whereas *riba* in sale of *al-muzabana* and *almuhaqala is* probable and despite that these two sales are prohibited[4].

Taking into account all these *fiqh* views, it becomes clear that rules regulating operations of IEFs depend on views of the minority of Muslim jurists. But the majority of Muslim jurists and corporate *frqh* circles see prohibition in trading stocks of shareholding companies which from time to time establish lending and borrowing contracts that involve usurious dealings.

Now IEFs are reality and in existence at least since the mid-90s. They operate in pursuance of the guidelines prescribed by Muslim bankers, practitioners and *frqh* jurists as described earlier in this section. The question now is the way they run their business which is claimed to be *Shari 'ah* compatible business. This is the subject of section II.

4 *Al-muzabana* is sale of fresh dates still on palm tree for estimated dried dates. *A!-muhaqala* is sale of wheat still on the spike (not yet harvested) for estimated dried wheat.

## ISLAMIC EQUITY FUNDS PROCEDURES AND POLICIES

Section one explains theoretical principles of operation of IEFs in general. Now ten equity funds will be assessed with respect to these principles. In addition, these selected funds will be comparatively analyzed to each other with respect to: investment policies, subscriptions, redemption, policies towards profit sharing and distribution, charges and expenses imposed, and risks associated with investments of these funds. They have been selected owing to availability of information about them.[5]

### 2.1 Compliance to *Shari'ah* principles

Without on exception, the ten equity funds under consideration follow exactly the same *Shari 'ah* rules and guidelines elaborated earlier in section I. Now IEFs find it easy to apply these criteria thanks essentially to set-up of Dow Jones Islamic Market Index (DJIMI) which is constructed from 2,700 stocks in the Dow Jones Global Index family.

The DJIMI is based at December 31, 1995, and is reviewed quarterly to reflect the latest trends and developments in the global stock market. The process of selecting *Shari* 'ah-compatible stocks is: (i) excluding stocks of companies that produce/distribute prohibited goods/services; (ii) the remaining universe of stocks is filtered by three financial ratios with the view to remove companies with unaccepExhibit financial ratios.

Filtration in this regard is undertaken to exclude companies if their: (a) total debt divided by total assets is equal to or greater than 33 percent; (b) accounts receivables divided by total assets is equal to or greater than 47 percent; (c) non-operating interest income divided by operating income is equal to or greater than 9 percent.

Companies passing this filtration are included in DJIMI invesExhibit universe, from which index components are selected (Dow Jones Islamic

[5] A concentration is made here on a sample of these equity funds only. In section III Islamic mutual funds of various types have been assessed.

Market Index, March 2000). However, the components of DJIMI may change based on the results of the quarterly review mentioned above. For instance, composition of the DJIMI as of December 31, 1998 was as what follows in Exhibit 1.

### 2.2 Investment Policies

Investment policies vary from one IEF to another. This difference may principally originate from differences at the front of investment objectives for each IEF. Moreover, the degree of risks expected has implications on investment policies of each of the ten IEFs under consideration. Thus, these funds adopt investment strategies as follow:

Al Kawthar Fund, concentrates on investments in a small number of securities.

The Global Equity Fund (of Al-Baraka) would not invest more than 10 percent of its NAV in one issuer's stocks.

**Exhibit 1**
**Composition of the DJIMI - December 31, 1998**

| Region | Weight | Sector | Weight |
|---|---|---|---|
| *Americas* | 70 % | *Consumer, non-cyclical* | 28 % |
| Europe / Africa | 20 % | Technology | 25 % |
| Asia / Pacific | 11 % | Utilities | 12 % |
| - | - | Energy | 11 % |
| - | - | Consumer, cyclical | 9 % |
| - | - | Industrial | 8 % |
| - | - | Basic Materials | 4 % |
| - | - | Independent | 1 % |
| - | - | Real Estate | 2% |
| **Total** | 100% | -- | 100*% |

*percentages add above 100 due to rounding off
*Source:* 2000 Dow Jones &.Company, Inc.

The Islamic Multi-Investment Fund adopts different investment restrictions in agreement with the several types of portfolios it structures. For

instance, it composes its portfolio, so that, between 20 to 40 percent would be in the form of parallel purchase and sale of currencies and commodities, and

between 20 to 40 percent as investment in global equities, and 15 to 30 percent shall be investment in emerging market equities. Investment of the Fund in Trade Finance is regulated in such away that, it would not expose more than 20 percent of net asset of this portfolio to any one country.

The DCB – RHB *Mudaraba* Fund (Malaysia) has its own set of investment policies including the condition that, no more than 10 percent of its assets would be abroad, i.e., outside Malaysia.

Al Khawarizim Fund will not involve in any deal for more than 20 percent of its gross assets, and it will not invest in non-markeExhibit securities of any single issuer which exceeds 20 percent of its assets. The Fund could borrow up to 50 percent of its NAV.

Ibn Majid Fund puts the condition that investments will be in equities of larger companies, and that investments would be in listed securities of companies in emerging markets. Moreover, it stipulates that it will not have investments in stocks of a single issuer for more than 5 percent, and holdings in the form of non-markeExhibit securities would be within 10 percent of its aggregate net assets.

The Small-Cap Equity Fund deals in shares of companies listed on stock exchanges in Europe, US Stock Exchanges, or included in the NASDAQ. Moreover, it stipulates that up to 30 percent of its portfolio would be in shares of these companies.

The Fund, and in exceptional circumstances, uses its assets in *murabaha,* so that, at least 5 per cent of its net assets will be held either in cash or in non-interest bearing deposits, or invested in *murabaha* transactions, or in other easily liquidated portfolios.

The Ibn Khaldoun International Equity Fund adopts conditions such as: the percentages of investments, in one company's securities shall not exceed 5 percent; the' Fund will not invest more than 25 percent of its total assets in any one single particular sector; the Fund shall not purchase securities not fully owned or those of new companies, or unquoted companies' securities.

The Citi Islamic Portfolio – Global Equity Fund would not invest above 10 percent of its net assets in transferable securities which are not listed on recognized stock exchanges. Further, the Fund will not invest more than 10 percent of its assets in securities issued by one issuer. The Fund shall not act as underwriter and shall not deal in securities which cannot be readily resold due to legal dispute.

Thus, depending on objectives, types of equities, markets, and risks that could be tolerated, IEFs under study adopt and stipulate different investment strategies. Yet, differences between IEFs in this respect are not so substantial. Funds used to copy each other, and compete each other by stipulating nearly the same conditions. This concentration in the same equities, and in certain markets, will not enable Muslim investors to benefit from all opportunities available.

**2.3 Subscription in IEFs**

On subscription, the three Funds sponsored by the International Investor (Kuwait) are targeting credit-worthy investors, so that the three require $100,000 as a minimum initial subscription.

Funds structured by other Islamic financial institutions such as Al-Baraka Islamic Investment Bank (Bahrain) impose less hard restrictions on minimum subscription.

For Al Kawthar Fund, the minimum subscription for individuals is US$15,000 and for the Global Equity Fund $25,000.

Both Funds of Al-Baraka Bank require an amount of US$250,000 as a minimum subscription for institutions. Thus, they differentiate between individual and institutional investors.

The two funds initiated and run by Faisal Finance S.A. demand US$50,000 as a minimum subscription. Hence, both the Islamic Multi-Investment Fund, and Adil Islamic Growth Funds are targeting the relatively creditworthy Muslim investors.

Ibn Khaldoun Fund, like Al Kawathar, wants US$15,000 as a minimum amount for participation.

The Malaysian DCB – RHB Fund is targeting middle-class Muslim investors with minimum subscription of MRs.50,000.

The least minimum subscription is that, of Citi Islamic Portfolio, which requires only US$10,000 for participation.

Thus, with respect to subscription, some IEFs target wealthy investors,

another category want to tap savings of the middle class, and the third group of IEFs chase the small Muslim savers (investors).

### 2.4 Redemption of investment units

On one hand, the IEFs under investigation are similar with respect to: (a) partial redemption which is allowed by all funds; (b) cancellation, suspension and deferral of redemption under circumstances such as the closing of markets where equities are dealt in, or when prices are so inappropriate; (c) reduction of the redemption amounts if they are big or significant enough to affect the remaining units; (d) if redemption leads to a resultant balance less than the minimum subscription, then this will be considered as total withdrawal from the fund; (e) refusal of redemption if it is less than certain minimum amounts. For instance, in case of Global Equity Fund of Al-Baraka, if redemption is for less than US$10,000 it will be refused.

On the other hand, they differ in the following aspects concerning redemption:

a) Some IEFs liquidate themselves and implement total compulsory redemption if their NAV is less than certain balance. In the case of Al Kawthar, for instance, this minimum is US$1 million. In the case of the Global Equity Fund, this minimum is US$15 million;

b) Some funds impose redemption fees while other do not. The Global Equity Fund (Al-Baraka), the Islamic Multi-Investments Funds (Faisal Finance), the Malaysian DCB – RHB *Mudaraba* Fund, Ibn Majid Fund and Citi Islamic Portfolio, all impose redemption fees ranging from 0.50 percent to 0.75 percent of the NAV. The other five funds do not impose such fees.

c) Furthermore, funds ;finder examination differ ·on the period within which ° redemption. payments are made – Al Khawarizim Fund, Ibn Majid Fund, Small Cap Fund all make payments of redemption ten days later when they receive redemption notices. For Citi Islamic Portfolio, redemption is carried out within 5 working days. The Malaysian DCB – RHB *Mudaraba* Fund is, however, the best that redemption is made daily and immediately.

d) Funds differ also on the start of redemption. For instance, for Ibn Majid Fund, Small Cap Fund and Adil Fund, redemption is allowed 12 months from the subscription date. Ibn Khaldoun allows redemption after 90 days of participation.

e) Finally, the IEFs differ on permission of units transfer. Some funds allow it to be to new as well as to existing unit holders, whereas

other don't offer this option. Ibn Khaldoun Fund, Adil Fund, and Citi Islamic Portfolio are the Islamic Funds which allow transfer of units, and other do not.

### 2.5 Policies towards profit distributions

Of these ten IEFs now under examination, not a single one reveals that it would make any distribution. All of them declare that they would accumulate all receipts and capital gains.

Moreover, all the funds disclose the fact that the un-guaranteed distributions that they would make in the long run would be made out of dividend income and capital gains. It is also revealed by all funds that the amount of distributions is discretionary and at hands of these managers.

The only exception is the Global Equity Fund of Al-Baraka Bank (Bahrain) which declares that it gives unit holders a choice between the distribution or the accumulation units. Thus, according to the distribution policy of this fund, unit holders who buy distribution units will be paid capital gains realized on frequent basis. Whereas those who hold accumulation units are not given distributions, and these distributions (profits) would be retained for capital appreciation.

Therefore, in this concern, the IEFs are similar in the profit-sharing policies that their objectives are realization of long-term capital growth and dividends would be reinvested in the funds' activities.

### 2.6 Strategies towards charges and fees

This is very crucial area which could directly affect investors' decisions whether to subscribe in this fund or that, depending on the types and magnitudes of charges and fees of each fund. IEFs vary with regard to fees they charge:

Some funds such as Al Khawarizmi Fund, the Small Cap Equity Fund, the Citi Islamic Bank and Islamic Multi Investment Fund, amortize initial fees over a couple of years. The other funds have not indicated such types of fees.

Among those that impose this type of fees, the Citi Islamic Portfolio Fund is of the least charge (US$20,000) whereas the Islamic Multi-Investment Fund incurs the highest cost among the group (US$24,000). This high initial cost may,

however, be attributed to the several (five) classes of portfolios that this fund structures.

Six IEFs of the sample impose subscription charges, or what is known as front-end fees. Al Khawarizmi and Small Cap Equity Funds of the International Investor (Kuwait) are Funds that put higher charges on subscription, 5 percent of NAV for each. Al Kawthar of Al-Baraka (Bahrain) comes next with front-end fee of 3 percent. Ibn Khaldoun applies the same cost margins on investors, i.., 3 percent.

The Global Equity Fund of Al-Baraka charges its investors with 1.5 percent of their initial subscription. This is the least fee among all funds.

However, unlike the other two funds run by the International Investor, which charges 5 percent, as is seen above, the Ibn Majid Fund is the least as compared to these two funds that charges subscription fees, it puts only 2 percent of the NAV as fees for participation.

Thus, some IEFs impose relatively higher subscription fees, others require low fees and a third group does not impose any such type of fees.

As redemption fee is concerned, with the exception of Al Kawthar Fund, all the nine Funds do not require redemption fees. Al Kawthar Fund itself imposes only 1 percent of NAV.

In this connection IEFs could be classified as equity funds which impose only low redemption fees, and this would encourage savers to invest in these funds.

Apart from the normal and ordinary operation fees, all funds charge their unit holders with the Manager Fee. Funds are similar that each calculates this fee as a percentage of NAV, though some funds give Manager the performance fees. However, the IEFs under study lay different rates on their unit holders as remuneration for Managers.

Given the Managers fee laid upon NAV, the higher rates are charged by DCB — RHB Fund and Ibn Khaldoun International Equity Fund, the rates are 1.5 percent of NAV of each. Rates for other funds range between 1.25 percent to 1 percent, **0.8 percent and** down to 0.75 percent.

Although some funds implement a single and straight-forward fees schemes, others apply an unclear fees structures.

For instance, the DCB – RHB, imposes in addition to 1.5 percent of NAV as annual Management fees, it lays other types of fees such as, service

charge fees calculated on a daily NAV, annual service charge of 0.5 percent of the amount subscribed, in addition to operations' fees.

Ibn Khaldoun Fund structured such a fee scheme which records Manager's fee in different ways, and the unit holder would not find it easy to figure out the exact fees amount.

The Islamic Multi Investment Fund, and as it manages five types of portfolios at the same time, charges investors with different rates as remuneration for the Managers.

Some funds, such as Al Khawarizmi, Ibn Khaldoun, Islamic Multi-Investment Fund, the Small Cap Equity, and the Global Equity Fund of Al-Baraka, all implement the performance fee paid either to the Manager alone, or to both the Manager and Investment Advisors.

For these funds which take performance fees, the aggregate fees magnitude is bigger, and thus, investors holding these funds' units would incur additional costs.

All funds are, however, common in other types of fees imposed, with little variations in rates and magnitudes of fees such as registration fees and initial offer fees.

To conclude, IEFs adopt low burden and straightforward fee structures whereas others designed such a cumbersome and costly fee schemes.

**2.7 Potential Risks facing IEFs**

All funds certainly face risks of operation as long as they deal in buying and selling shares and equities of other companies. But some funds are -more largely exposed to particular risks than others. The common risks for all IEFs crystallize around the following:

a) the risk of adherence to *Shari 'ah* rules which prevents all IEFs from certain transactions even if these transactions are pretty profitable;

b) the securities trading in which IEFs deal is directly affected by factors such as, economic conditions, ups and downs in business and finance, and in world affairs;

c) other factors could bring risk to IEFs, such as government policies, climate conditions and fluctuating exchange rates and economic conditions in general;

d) the risk of illiquid investments;

e) the risk of conflict of interest which might arise as Investment Advisors of IEFs may buy or sell securities to the benefit of IEFs as well as to their competitors;

f) the risk of extra regulations in certain economies where IEF have existence or registered;

g) risk that arise due to the fact that, these IEFs are new entrants into the field, they do not have trace record.

The special risk categories are in connection with holdings of IEFs in emerging markets as these markets are characterized by: (a) financial volatility; (b) investment and repatriation restrictions; (c) the risk of settlement which carries with it the problem of ownership transfer; (d) high probabilities of illiquid positions; (e) risks of exchange rate fluctuations; (f) risk of restriction on buying and selling certain securities; (g) lack of the standard reporting capabilities; (h) lack of disclosure requirements as compared to those applied by companies in the recognized stock exchange.

Funds working in the Small-Cap Equities are faced with risk of Small-Cap Companies characterized by uneasy financial positions and relatively small market capitalization. Moreover, there are less quantitative and qualitative data available about companies and equities in these emerging markets.

Some IEFs face concentration risk for some funds which deal in certain equities that may change in value.

Thus, performance of IEFs might more likely be affected by these special types of risk. Furthermore, and as mentioned just above, IEFs are encountered by the 'special type of risk that could arise due to adherence to *Shari 'ah* rules via:

(i) not dealing in certain shares though their markets are flourishing, growing and profitable so that their unit holders would not benefit from this, and,

(ii) the purification of a certain percentage of income of IEFs as their percentage is attributed to gains from illegal (interest rate) activities of the company whose shares are component part of the Islamic Equity Fund's portfolio. Therefore, returns to unit holders would be relatively lower as compared to conventional funds.

**2.8 Further issues related to IEFs**

These IEFs have some features in common that:

a) they all trade on equities in the same area of investment;

b) they heavily depend on foreign asset managers. This would entail extra costs and possibly moral hazard and negligence of *Shari 'ah* criteria;

c) Muslim investor is not provided with detailed analysis of the equity market and their prospective futures. This bottleneck might be relieved overtime with existence of DJIMI;

d) IEFs will perhaps remain for some time dependent on technical and professional advises of foreign assets managers. They may therefore be restrained from having full exposure to market information;

e) How can IEFs, as new entrants market their products to their investors**.** In particular, what are the information sources for investors who want to participate in the IEFs? Marketing channels are yet less effective to penetrate the target group of investors, especially small and middle-class savers;

Section III below evaluates performance of some of the IEFs including another category of Islamic mutual funds.

# ISLAMIC EQUITY FUNDS — PERFORMANCE ASSESSMENT

The Islamic mutual funds chosen here for further elaboration are those of the National Commercial Bank — based in Jeddah, Saudi Arabia, and the funds operated by Al-Baraka Group also based in Jeddah. The funds run by these two institutions have been chosen due to their serious attempt in developing mutual funds on Islamic basis, and in different areas, not only equity funds. However performance of some other Islamic funds in Europe and the United States have been reflected here in an attempt to touch their performance as well. In particular, the Amana Fund will be discussed as representing an Islamic mutual fund working in the West.

## 3.1 The National Commercial Bank (NCB)

Al - Ahli has three types of funds with respect to risk: (a) short-term funds and this category includes the Islamic International Trade Fund; (b) medium-term funds and among this class the Islamic fund is: Al-Salam Commodity Fund; (c) long-term funds where Al-Ahli has the Global Trading Equity Fund. In 1998, two more Islamic funds have been founded, namely, Al-Ahli Saudi Equity Trading Fund and, Al-Ahli Small Cap Trading Fund.

Until late 1998, the NCB runs 19 mutual funds, four of which are of short-term nature, four are of medium-term nature, and 11 are for long-term and relatively high risky investment. Out of the 19, six are run on Islamic basis and some of them are elaborated here with special emphasis on their (i) performance and, (ii) diversification.

### *3.1.1 The Global Trading Equity Fund (GTEF)*

The Fund was launched in late 1994 as an open-ended equity fund. The annual management fee is 1.75% of the value of assets under management. The Fund's holdings are evaluated on weekly-basis. Withdrawal is allowed every week. The Fund's objective is capital appreciation by trading in global equities without transgressing *Shari 'ah* laws:

#### I. Portfolio Diversification

The NCB is managing the Fund through its agent the Wellington Management Company. The latter sells and buys shares of the selected companies on request and order of the NCB. As of the period ended August

1996, the statistics on the Fund disclosed the following portfolio structure as shown by Exhibit 1.

**Exhibit 1**
**GTEF Holdings: Sector Distribution**

| Industry | Weight % |
|---|---|
| Consumer, Discretionary | 10.9 |
| Consumer, Staples | 4.6 |
| Energy | 13.2 |
| Health | 13.4 |
| Industrial & Commercial | 9.8 |
| Information & Travel | 10.7 |
| Information & Technology | 23.8 |
| . Materials | 2.7 |
| Utilities | 9.3 |
| Real Estate | 1.6 |
| **Total** | **100.0** |

Source*:* **NCB,** Islamic Banking Division, 1996.

Thus, shares of information technology companies represented nearly one-fourth of the total holdings of the Fund as at that date. The companies dealing in the health matters came the second as a sector in whose shares the Fund deploy its money. Then comes shares of companies in the energy sector. Shares of companies in other economic activities had different portions as components of the assets of the Fund. For instance, the Fund kept 10.7% of its assets in shares of the information and travel companies and 9.8% in those of the industrial and commercial companies.

At the level of regional distribution of the Fund portfolio, shares of companies working in the United States / Canada and in Europe represented the majority of holdings, 46.7% in US / Canada and 30.7% in Europe. The remaining was predominantly in the Asian emerging markets which was 22.0% and only 00.6% in other countries, (see Exhibit 2).

**Exhibit 2**
**GTEF Holdings: Geographical Distribution**

| Region | Weight(%) |
|---|---|
| Europe | 30.7 |
| U.S./Canada | 46.7 |
| Asia | 22.0 |
| Other | 00.6 |
| **Total** | 100.0 |

*Source:* NCB, Islamic Banking Division, 1996.

Compared to the Global Trading Equity Index and to MSCI World, the NCB Global Trading Equity Fund held, as at March 31 1996, equities of the international companies that the Fund examined from the *Shari 'ah* point of view are as follows:

**Exhibit 3**
**NCB Global Trading Equity Fund: Country Weights***

| | | ***MCBGTEF*** | ***GTEI##*** | ***MSCI*** |
|---|---|---|---|---|
| ***Europe*** | *UK* | *11.3%* | *13.7%* | 9.3% |
| | Germany | *8.9* | *9.0* | *4.0* |
| | Netherlands | *6.5* | *6.0* | *2.3* |
| | Switzerland | 4.1 | 3.4 | *3.5* |
| | Sweden | *3.0* | *3.0* | 1.2 |
| | Denmark | 1.4 | 1.2 | *0.4* |
| | France | *0.8* | 1.8 | *3.7* |
| | Others | **0.0** | **0.4** | **3.9** |
| | | *36.0%* | *38.5%* | *28.3%* |
| ***Asia*** | Japan | **18.0** | 16.1 | *22.5* |
| | H. Kong | *4_4* | *3.2* | 1.9 |
| | Singapore | *2.7* | *1.4* | *0.8* |
| | Malaysia | **2.6** | **3.5** | **1.4** |
| | | *27.7%* | *24.2%* | *26.6%* |
| ***U.S./Canada*** | U.S.A. | *35.1* | *34.1* | ***41.4*** |
| | Canada | 0.6 | *2.6* | *2.2 .* |
| ***Others*** | Australia | **0.6** | **0.6** | **1.5** |
| | | 0.6% | 0.6% | 1.5% |

* percentage of equities; ** GTEI = **Global Trading Equity Index.**
*Source:* NCB, Islamic Banking Division, *1996.*

However, the above distribution of holdings of the Fund indicates that it was very nearer to that of the GREI and to that of MSCI World.

In 1998, the Fund's portfolio showed heaviest exposure in stocks of companies in America and Europe to the extent that 67.2% was its holdings in USA/Canada and 26.2% in European stocks and 5.8% in Japan.

## II. Performance

Total returns on shares of the Fund were higher than returns on shares of the companies included in MSCI World Index and were also higher than

return on shares of the Global Islamic Equity Index as reflected below by Exhibit 4.

**Exhibit 4**
**Total Returns - period ending August 31, 1996**

| | 1Mon | 3Mons | Year to date | 12Mos | since inception |
|---|---|---|---|---|---|
| GTEF | *2.0%* | *-1.6%* | ***9.6%*** | *17.1* | ***34.9%*** |
| Global Islamic Equity Index | 1.8% | -1.0% | 7.5% | 13% | *33.2%* |
| MSCI World Index | 1.2% | -1.9% | **4.8%** | 13.1% | *27.1%* |

Return since inception date of December 1994 are cumulative.
*Source:* NCB, Islamic Banking Division, 1996.

Prices of the investment units of the Fund witnessed growth over time. An amount of US$ 5,000, the minimum initial subscription, grew as follow: US$5177.75 for more than three-month period; US$5375.03 for more than six-month period; US$5836.14 for more than a year and, US$6771.33 since inception in January 1995, (NCB, Report on Investment Funds, 1996).

Units grew in terms of prices from 1 dollar in January 1995 (the launching date) to US$1.1 in the mid-1995, US$1.15 in January 1996.

The Fund Management adopted such an investment strategy so that it invests short-term liquidity in short term *murabaha* transactions in order to secure the return comparable to that on World shares. The strategy was also adopted for the sake of diversifying the portfolio on country basis and on sector basis.

In 1998, the Fund registered good return (36.3%) and was one of the best performing funds among the funds run by Al-Ahli. Since inception , the Fund has an average return of 27.7% per annum. Cumulative return reported was: 36.29% for one year, 49.49% for two years and, 82.76% for three-year period.

### *3.1.2 Al Ahli Saudi Equity Trading Fund*

This is a long-term fund which targets investors seeking capital appreciation from stocks of Saudi companies. Exhibit5 below show sectoral distribution of the Fund's portfolio for 1998. The Fund incurred a negative (-9.26%) rate of return for the year 1998 as there was a general decline in the Saudi stocks during that period.

**Exhibit 5**
**Saudi Trading Equity Fund — portfolio distribution across sectors, 1998**

| No | Sector | % age share |
|---|---|---|
| 1. | Industrial | **24.4** |
| 2. | Murabaha | 24.0 |
| 3. | Cement | 23.9 |
| 4. | Services | 9.9 |
| 5. | Islamic banking | 9.1 |
| 6. | Cash | 7.0 |
| 7. | Agriculture | 1.7 |
| | Total | 100.0 |

*Source:* Al-Ahli Mutual Funds Review, 1998.

#### *3.1.3 NCB International Trade Fund*

This is another investment fund run by the NCB on Islamic basis. It started as a traditional investment fund in March 1987 and then transformed to work on Islamic basis. The National Center for Managerial Services[6] amended conditions of the contract and now the Fund is run on *Murabaha* basis.

The Fund invests in short-term, high quality international trade transactions. As an Islamic one, the Fund does not trade in gold, silver or currencies in accordance with murabaha principles. The Fund aims to provide investors with capital preservation from short-term murabaha-based US dollar investments and liquidity.

#### I. Portfolio Diversification

Diversification technique is adopted to protect the value of units against depreciation. Therefore, on sector-wise, the assets under management are distributed among companies working in different activities such as, car production, metals and petroleum products.

In 1996, 37.3% of the assets were metals that the Fund trades in, 30.22% were soft commodities, 16.25% were finished goods, 8.13% were steel products, 7.30% oil products, 0.59% were miscellaneous commodities whereas the assets in cash form were only 0.14%, (The NCB, Booklet on Investment Funds, 1996).

[6] The consulting body that provides consultancy services to the NCB regarding *Shari'ah* aspects of its work.

As of the end of 1998, the Fund's portfolio favored positions in non-precious metals and commodities as follows: soft commodities (30.4%), metals (39.1%), finished goods (13%), steel products (10.3%), energy (7.3%).

**II. Performance**

The minimum subscription in the Fund is US$2,000. For the last 1994-1996 period, the Fund's units grew annually by 3.78%. Over the period 1990-1996, the units prices grew from US$1.2 per unit in January 1990 to US$1.55 in January 1996. .

However, records about the Fund shows that the minimum subscription of US$2,000 grew as follow according to period it remained with the Fund for investment: (a) remaining for more than three months, it grew to US$2021; (b) remaining for more than 6 months, it increased in value to US$2041; (c) remaining for more than 12 months, it increased in value to US$2086 and, (d) since launch, the minimum subscription grew to US$3172. The Fund performance with respect to return is measured against two parameter: LIBOR of London and the return realized by the other counterparts.

In late 1998, the unit price was US$1.7470. cumulative returns were: 4.41% for one year, 9.01% for two years and, 13.63% for three years.

### *3.1.4 The Saudi Riyal Trade Fund*

This Fund is very similar to the former one. Almost they are identical except that the International Trade Fund is in dollar whereas the latter is in Saudi Riyal. It was launched in March 1996 with the objective of maintaining capital and providing liquidity on demand.

I. **Portfolio Diversification**

The majority of assets under management of the Fund till September 1996 were metals (52.5%), soft commodities (25.24%), consumer products (12.05%) and oil products (10.11%). Assets in cash form were as low as those of the International Trade Fund, they were only 0.9%.

In 1998, the fund's portfolio showed strong positions in non-precious metals and soft commodities. In this year metals represented 50.3% of its portfolio**,** soft commodities represented 30.4% and finished goods and steel products represented 14% of the portfolio**,** (Al-Ahli Mutual Funds, 1998 Review).

## II. Performance

The annual rate of return over one year, September 1995 – September 1996, was 4.89%. A benchmark for measuring this rate of return was the LIBOR. Units of the Fund grew in value over time. An amount of SR 10,000 – the minimum subscription – grew in value as follow: reaching SR 10111 for three months; SR 10234 after six months; SR 10489 after a year and 10755 since launching of the Fund. Unit prices increased from SR 1 in March 1995 to SR 1.07 in August 1996.

In 1998, the unit price was SR 1.2042. The Fund's returns remained essentially the same in 1998 when compared to the previous year. Cumulative returns were 5.3% for one year, 10.64% for two years, and 15.96% for three years.

### *3.1. 5 Al Salam Commodity Fund*

*Al-Salam* Fund has started in the mid-1996. The Fund objective is to provide *salam-based* investment, to benefit from changes in market prices of the commodities. The Fund is fully exposed to price movements in the commodities in which it is invested.

The minimum subscription is US2,000; Redemption is allowed on the subscription day and must be for a minimum value of US$1,000; periodic valuation of the Fund assets is undertaken on a monthly basis. The valuation is used in determining the unit value, and the `bid' and `offer' prices of the units; the manager charges the Fund on every `subscription day' for the services it provides; the fee rate is 1.75% of the net asset value (NAV) of assets under management.

The *Salam* Fund is a medium-risk dollar-denominated fund designed to obtain a diversified exposure to commodity markets on *salam* basis. The fund aims to provide investors reduce risk by diversifying across commodity type, reduce volatility and stabilize returns by investing a proportion of the fund in murabaha transactions and provide monthly liquidity.

## I. **Portfolio Diversification**

Holdings of the Fund are evenly distributed between grains (25.08%), short-term *murabaha* transactions (24.45%), metal products (25.18%) and energy (25.29%).

In grain sector, the Fund's holdings were in the corn, wheat and soybeans. Holdings in short-term *murabaha* transactions include diversified *murabaha* transactions and transaction between this Fund and the International Trade Fund. Metal products upon which the Fund established *salam* contract were aluminium, copper, zinc and nickel. As for energy sector, the Fund transacted for crude oil, heating oil and unleaded gasoline.

Late 1998, *Al-Salam* Fund's portfolio showed nearly equal weighting in murabaha transactions (25.0), energy (25.1%), metals (25.1%) and, grains (24.8%), (Al-Ahli Mutual Funds Review, 1998).

**II. Performance**

Records on operations of the Fund are yet inadequate and incomplete owing to the fact that the Fund is still new just starting in July 1996. Despite that, the available statistics show the growth in value of the units. Unit prices increased from US$0.90 when the Fund started in July, to US$1.05 in September 1996. The value of the US$2000 the minimum initial subscription, increased to US$2071.39 over the three months from July to September 1996.

In 1998, the Fund showed a negative return of over 25% reflecting the declining commodity market. Unit price in 1998 was US$0.7343.

### *3.1.6 Al Ahli Small Cap Trading Equity Fund*

This is a new fund (in 1997) which provides investment outlets in equities (mainly US) of relatively smaller companies with high capital growth potential. As of December 1998, the Fund's portfolio was spread across a number of countries and sectors. Most of the Fund's portfolio were in US stocks (92.6%), and the remaining was in Europe.

## 3.2 Al-Baraka Mutual Funds

The other company which has experience in mutual funds is Al-Baraka Company. Al-Tawfeek Company – a subsidiary of AI-Baraka - is running several funds working in . different investment activities and in different countries. Moreover, all funds are designed to be operated in compliance to Islamic principles.

Classified on the basis of risk-degree, Al-Baraka funds fall into four main categories as:

**(a) Low-risk funds: like Al-Baraka General Fund;**

(b) Medium-risk funds: these are leasing funds such as: GCC Leasing Fund, the International Leasing Fund;

c) Moderately-risk funds: are some of the equity funds, e.g., *Al-Safwa* International Equity Fund, *Al-Nukhba* Fund, and *Al-Sukoor* Equity Fund

d) Highly-risk funds: these are equity funds based on acquisition of small and medium size companies with potential long-term returns.

Al-Tawfeek company initiates, creates, and develops mutual funds structured to transact a broad range of equities and assets including leasing funds. Till mid-2000, there are ten mutual funds run by this company, (Exhibit 6 below).

**Exhibit 6**

**Al-Tawfeek Company's Mutual Funds – till June 2000**

| **Mutual Fund** | **Issued capital (US $ Million)** |
|---|---|
| AlBaraka General Fund | 300 |
| Lebanon Reconstruction Fund | 200 |
| US Real Estate Fund | 52 |
| GCC Leasing Fund | 100 |
| Al-Sukoor Equity Funds | 100 |
| GCC (2) Leasing Fund | 50 |
| International Leasing Fund | 50 |
| Al-Safwa International Equity Fund | 50 |
| Al-Nukhba Asia equity Fund | 50 |
| Children Investment Fund | 10 |

**Exhibit** 7
**Portfolio Distribution – May 2000**

| **Type of portfolio** | **Volume (US$ 000)** | **%** |
|---|---|---|
| Murabaha | 104557.68 | 17.28 |
| Real Estate on operating lease | 65483.75 | 10.82 |
| Financial Lease | 112840.98 | 18.65 |
| *Mudarabah* | 1055.23 | 0.17 |
| Equity Participation | 223051.20 | **36.86** |
| Local Stock Portfolio | 53766.61 | **8.89** |
| Int'l Stock Portfolio | 40655.01 | 6.72 |
| Egyptian Stock Portfolio | 584.21 | 0.10 |
| Malaysian Stock Portfolio | 3077.13 | 0.51 |
| **Total** | **605071.8** | **100%** |

***Source:*** Malaika, Saleh J, June 2000G.

In general, Al-Tawfeek investment portfolio is characterized by concentration of investment in equity participation. Stock portfolio represented 16.22 per cent of total investments till May 2000. Exhibit 7 reflects portfolio distribution including stock portfolio. Here is an assessment of some of the funds run by Al-Tawfeek.

### *3.2.1. Al-Baraka General Fund*

The Fund is classified as low-risk fund. Its objective is to invest in the GCC States. The authorized capital is US$500 million and the issued capital US$300 million. The Fund will work for 15 years starting from 1992.

Withdrawal is allowed given the following conditions: (i)US$50,000 or less is liable for immediate withdrawal without notice; (ii) withdrawal of US$250,000 or less needs to be reported two days earlier; (iii) for US$2,500,000 the investor has to give notice six days earlier and; (iv) above US$2,500,000 needs arrangement with the *Mudarib.*

There are three categories of investment units via: (1) Category "A" where units are liquidated on demand; (2) Category "B" units are liquidated

every three months and, finally; (3) Category "C" which are liable for liquidation only on annual basis.

## I. Diversification

The Fund portfolio was distributed according to Islamic modes of finance in 1994 as: 25% in cash form and short-term investments; 14% was leased-end-to ownership operations; 8% as *mudarabah;* 4% were participation in equities; 2% were deposits in Islamic banks and 9% were investments in financial assets.

However, the Fund distributed its holdings among modes of finance in 1995 in such a way that lease-end-to ownership had the bigger share of 33% instead of 14% in 1994. Equity participation increased to 21% more than 5 times its percentage in 1994 which was only 4%. Assets in the operational lease were 16% in 1995 whereas the Fund had no asset in this operational lease in 1994. Holdings in *murabaha and* short-term investment were less this year 1995, only 11% whereas they were 25% in the year before. A small percentage of investments were in real estate in 1995, just 1%, (Al-Baraka Group, General Investment Fund, 1995).

Assets under management of the Fund in 1994 were in different countries with a big share being in the United States (19%) and Turkey (14%). 12% of these holdings were in Algeria and Saudi Arabia for each whereas in Morocco, Pakistan and Malaysia the Fund had 9%, 7% and 6% in each respectively.

Such regional distribution of the Fund assets indicates that a big share of the Fund investment were in Muslim countries. The *Mudarib,* AI-Tawfeek Company, chooses the relevant country for investment according to certain criteria including: investment opportunities available in a given country, stability of the economy in terms of growth rates, inflation rates and fluctuations in currency value.

In May 2000, sectoral distribution of the Fund portfolio discloses greatest concentration on commodities (33.67%), followed by direct financing to individuals (21.94%) and then commercial sector (10.85%), (Exhibit below).

**Exhibit 8**
**Al-Baraka General Fund — Portfolio Allocation, May 2000**

| No. | Portfolio type | %age share |
|---|---|---|
| 1. | Commodities | 33.67 |
| 2. | Financing Individuals | 21.94 |
| 3. | Commercial financing | 10.85 |
| 4. | Contracting | 8.61 |
| 5. | Health sector | 8.17 |
| 6. | Industrial finance | 6.19 |
| 7. | Real Estate sector | 3.14 |
| 8. | Media | 2.82 |
| 9. | Financial services | 2.35 |
| 10. | Services sector | 2.26 |
| **Total** | | **100.00%** |

*Source:* Malaika, Saleh (2000).

## II. Performance

Performance of the General Fund is elaborated in terms of three main issued units which are most liquid: (a) Unit A is liquefied at any time with no restriction; (b) Unit B which is redeemable every three months and, (c) Unit C is entitled to annual redemption.

For the 1994, net profit rates for the three classes of units were as shown by Exhibit 9 blow. The Fund capital doubled over the period 1992 — 1994 as it increased from US$ 83 in 1992 to US$ 194 in 1994.

**Exhibit 9**
**Al-Baraka General Fund Prices Per Unit Categories, 1994**

| | "A" Units | "B" Units | "C" Units |
|---|---|---|---|
| March | 1.7% | 3.55% | 4.5% |
| April | 1.94% | 3.84% | 4.88% |
| May | 2.3% | 4.2% | 5.32% |
| June | 2.69% | 4.52% | 5.99% |
| July | 2.63% | 4.4% | 5.88 |

*Source:* Al Tawfeek Company for Investment Fund, 1995

The number of investors rose from 350 to 1772 over the same period. This number reached 3152 by April 1995.

Over the period February 1999 and February 2000, the average rate of return was as follows for the three types of units: Unit C: 7.5%; Unit B: 5.6%; Unit A: 3.4%. thus, the less liquid units (C unit) had higher return as they stayed for relatively longer period in investment.

### *3.2.2 The Gulf Cooperative Council Leasing Fund*

As said before, Al-Barak runs funds of medium-risk nature such as the Gulf Cooperative Council Leasing Fund (GCCLF) and the International Leasing Fund.

Established in the second half of 1995, the GCCLF is an open-ended fund to invest in different sectors in the GCC States on leasing basis. The Fund investment strategy and objectives are to invest local currency in diverse leasing transactions over the medium term, (Al-Tawfeek Company for Investment Funds, Prospectus on GCC Leasing Fund).

Each unit value shall be US$1000 during the initial subscription period. The initial minimum subscription is US$5000. The minimum for addition or redemption is the value of one unit. The Fund's profits are reflected in prices of units declared weekly.

### I. Diversification across industries and countries

The Fund's strategy in this regard is to invest in diversified investment strategies. Lease transactions of the Fund represent the bulk of holdings and **assets** under management. They include leasing in automobile and heavy trucks, medical and industrial equipment, real estate such as, private houses, residential compounds, offices and retail buildings.

The portfolio distribution by sector has expanded from 5 to 8 sectors. As at February 1996, 38.69% of the portfolio was in tourism sector, 13.86% were investments with individuals, 12.24% of the Fund portfolio was in the media sector, holdings in the industrial sector were 11.26%, investments in real estate and commodities sectors represented 8.62% and 8.1% respectively. The Fund assets in transport equipment was 5.43% and the medical sector had the minimum shares of the fund holdings, only 1.8%.

The data about the Fund regarding portfolio structure by maturity discloses that 43.25% of the assets under management were for the short-term,

43.68% will be of medium term maturity whereas the remaining 13.07% are maturing in the long run for more than 5 years.

Sectoral profile of the GCCLF has been changing over year. In the year 1999/2000, portfolio of the fund uncovers larger concentration on real estate (38.7%), followed by investment in education sector and financial services sector respectively (Exhibit 10 overleaf reflects this change).

**II. Performance in comparison to certain standardized indexes**

Unit prices grew within the first seven months following the start in mid-1995, from US$1000 in August 1995 to US$1048 in February 1996. The expected rate of return is 8%. However, there are several factors that determine and affect performance of the Fund. Among these are the following: (a)· changes in the value of currencies, i.e., exchange rates movements of the currencies; (b) returns from leasing transactions may be lower than the market in the future if market lease rates rise while the Fund is still locked in existing lease rates. Thus, rigidities in lease contract affect the rate of return; delay and defaults in payments of the rents of leased assets would reduce the real rates of return, particularly when clearance of these delays and defaults involve legal procedures and increased costs on legal matters.

**Exhibit 10**
**GCCLF Portfolio Profile – 1999/2000**

| NO. | Type of Investment Holdings | % age share |
|---|---|---|
| 1. | Real Estate | 38.68 |
| 2. | Education services | 17.06 |
| 3. | Financial sector | 13:60 |
| 4. | Commodities | 11.04 |
| 5. | Commercial sector | 6.98 |
| 7. | Financing individuals | 4.60 |
| 8. | Miscellaneous financing | 3.5 |
| **Total** | | **100.00** |

***Source: Al Baraka Group, 2000.***

For the six-month period from August 1999 to February 2000, the average rate of return was 7.34%. Exhibit 11 below shows rate of return for this period which was low in November and December then improved to register a remarkable increase in February.

**Exhibit 11**
**GCCLF — RATE OF RETURN**

| Period | Rate of Return |
|---|---|
| August -1999 | 7.46 |
| September- 1999 | 7.43 |
| October - 1999 | 7.32 |
| November - 1999 | 7.22 |
| December - 1999 | 7.23 |
| January - 2000 | 7.23 |
| February - 2000 | 7.49 |

*Source: Al-Baraka Group, 2000.*

### *3.2.3 The International Leasing Fund (ILF)*

## I. Diversification

Al-Tawfeek Company acts as *Mudarib* for another lease fund which is the International Leasing Fund started also in 1995. The Fund, which is an open-ended one, diversified its portfolio as at February 1996 as follow: 34.1% in the public sector, 21.2% in the petroleum sector, 18.24% in the real estate, 16.9% in tourism, 5.4% in transport and 5.15% in the financial instruments.

Geographical placements of the Fund investments reflects that 22.06% of holdings were in Saudi Arabia, 21.2%.in Singapore, then 18.24% were in the United States and 4.4% were in the United Kingdom. Investments in other places were much more than in any other single country, being 34.1% as at February 1996.

Sectoral profile of the International Leasing Fund reflects big concentration in services (65%), followed by investment in energy sector (23%). Investment in real sector comes in the third place and lastly the financial services' sector (3%), as disclosed by the exhibit below:

**Exhibit 12**
**International Leasing Fund — Investment Distribution, 1999/2000**

| No. | Type of portfolio | % age share |
|---|---|---|
| 1. | Services | 64 |
| 2. | Petrol sector | 23 |
| 3. | Real Estate | 10 |
| 4. | Financial services | 3 |
| Total | .................. | 100 |

**II. Performance**

The performance for the ILF shows an average rate of return of 6.51% over a ten-month period extending from February 1999 to November 1999. As reflected by Exhibit13 below, the higher rate of return was in November (6.73%) whereas the lower rate was in February (6.46%). On the whole, rate of return on investment of the ILF is lower that that on investment of the GCCLF.

**Exhibit 13**
**GCCLF – RATE OF RETURN**

| Period | Rate of return |
|---|---|
| February | 6.46 |
| March | 6.47 |
| April | 6.48 |
| May | 6.49 |
| June | 6.42 |
| July | 6.51 |
| August | 6.51 |
| September | 6.56 |
| October | 6.52 |
| November | 6.73 |

### *3.2.4 Al Safwa International Equity Fund*

This is a moderately-risk open-ended fund with the objective to generate medium to long-term capital growth by investing in *Shari 'oh*-compliant diversified portfolio of equities listed and traded in the world stock exchanges.

Initial subscription started in March 1996 with minimum subscription of US$ 100,000 and an initial unit price of US$1,000. The Fund is an open-ended, limited liability company incorporated in the Cayman Islands. It was designed to invest its capital in a portfolio of equity. securities and manage such portfolio on behalf of investors pursuant to an agency contract.

The Fund target capital is US$50 million during the initial subscription period and an authorized capital of US$ 200 million.

**I. Portfolio Diversification**

The screening process adopted by the Fund filters out securities of companies undertaking non-Islamic activities, securities of companies with a high "debt to equity" ratio (5% and above), and a high "interest / income" ratio.

The investment adviser to the Fund has developed certain criteria constructing and managing the Fund holdings, that is called the Arbitrage Pricing Technique (APT). By using the APT, the Fund diversifies stock selection to reduce risk and maximize returns. The screening outcome was that only 5% of the stocks were found as stocks of companies that can-be classified as accepExhibit from the *Shari'ah* point of view. These were only 560 companies.

Geographical distribution of the fund's placements in 1999 indicates that, 80% of the fund's portfolio was concentrated in USA, Europe and Canada, with the remaining 20% in the Pacific-rim countries, (see Exhibit below).

On sector basis, distribution of the fund's portfolio discloses greater focus on trading in shares of companies that work in technology followed by companies working in production of cyclical basic materials, (see Exhibit 14 below).

**Exhibit 14**
**Al-Safwa Fund – Sectoral & Geographical**
**Portfolio Distribution**

| No. | ::Sector | % age share | Region | %age share |
|---|---|---|---|---|
| 1. | Technology | 39 | USA | 42 |
| 2. | Cyclicals | 20 | Europe. | 25 |
| 3. | Non-cyclicals | 16 | U.K. | 9 |
| 4. | Industrials | 12 | Pacific | 20 |
| 5. | Energy | 9 | Canada | 4 |
| 6. | Utilities | 4 | - | - |
| **Total** | | **100.00** | - | **100.00** |

***Source:*** Al-Baraka Group, 2000

These statistical findings imply that investments of this fund were exclusively outside the Muslim world. Further its investments were essentially in stocks of the technological and industrial companies.

## II. Performance in comparison to certain standardized indexes

Owing to the fact that Al Safwa started only in March 1996, there are not yet adequate information about performance of the Fund. However, the Fund Manager's target is to ' compete returns on stocks of companies that are

among the Morgan Stanley Capital Index (MCSI) and Standard & Poors (S & P) benchmark.

According to findings of the Fund Manager, historical performance of shares of the companies which the Manager selected on Islamic basis by suing the above-mentioned Arbitrage Pricing Technique (APT), exceeded the comparable performance of shares of companies included either in MSCI Global or in S. & P. Exhibit15 show the performance of the shares in which Al Safwa will invest compared to MSCI and to S. & P.

**Exhibit 15**
**Arbitrage Pricing Technique Performance**

| | APT Value Linked. Vs S &B Benchmark | | APT Global Linked Vs MSCI Global | |
|---|---|---|---|---|
| | *APT(%)* | S&P 500(%) | APT(%) | *MSCI(%)* |
| 1991 | 45.09 | 30.55 | 15.01 | 18.98 |
| 1992 | 11.09 | 7.67 | -6.63 | -4.66 |
| 1993 | 13.74 | 9.99 | 27.15 | 23.13 |
| 1994 | 4.14 | 1.31 | 9.79 | 5.58 |
| 1995 | 36.8 | 37.53 | 25.30 | 20.7 |
| Cumulative Returns | 161.17 | 115.41 | 87.83 | 77.99 |

**Exhibit 16**
**Returns earned on Funds managed under APT Process**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 1994 | 4 Quarters | 4.44 | 1.31 | -1/3 | 9.79 | 4.14 | -0.71 |
| 1995 | Year-to-Date | 30.9 | 29.7 | 27.2 | 11.1 | 12.2 | 7.1 |
| 1995 | 1st Quarter | 9.94 | 9.74 | 7.16 | 1.43 | 1.93 | -1.85 |
| 1995 | 2nd Quarter | 9.43 | 9.49 | 8.71 | 4.26 | 4.26 | 4.04 |
| 1995 | 3rd Quarter | 8.83 | 7.95 | 8.91 | 5.09 | 5.59 | 4.91 |

*Source:* Al Tawfeek Company for Investment Funds, Al Safwa Fund, 1996.

### *3.2.5 Al Nukhba Fund*

Like Al-Safwa Fund, Al-Nukhba is a moderately-risk open-ended Fund. It has been launched to deal in stocks of Asian and Pacific companies. The fund is structured mainly for those seeking capital appreciation over medium-to-long-term time span, and in compliance with Islamic principles. Its issued capital is US$50 million.

#### I. Diversification

The fund focuses on investment in stocks of companies which work in the production of machinery goods which come in the first place, then communication and telecommunication. Exhibit17 uncovers figures on sectoral distribution of the fund portfolio for the year 1999-2000. Investment in corporate shares in machinery, electric machinery, communications, telecommunications and transport absorbed 62.63% of the total fund's investments.

**Exhibit 17**

**Al-Nukhba Fund — Investments' Sectoral Breakdown**

| No. | Sector of Investment | % age share |
|---|---|---|
| 1. | Machinery | 36 |
| 2. | Communication | 14 |
| | Real Estate | 8 |
| 4. | Services | 8 |
| 5. | Telecommunications | 7 |
| 6. | Miscellaneous | 6 |
| 7. | Transport | 5 |
| 8. | Electric/precision pro. | 4 |
| 9. | Retail/wholesale | 4 |
| 10. | Chemicals | 3 |
| 11. | Machinery | 3 |
| 12. | Rubber | 2 |
| **Total** | | **100** |

Geographical dispersion of the portfolio was towards Japan where the fund invests nearly 87% of its resources in stocks of Japanese companies. Because the fund is structured to deal in stocks of the Asian and Pacific companies, the remaining balance of its portfolio is composed of shares of companies in Hong Kong and Singapore (Exhibit 18).

**Exhibit 18**
**Al-Nukhba Fund – Investments' Geographical Breakdown, 1998-2000**

| No | Region of investment | %age share |
|---|---|---|
| 1. | Japan | 86.88 |
| 2. | Hong Kong | 8.18 |
| 3. | Singapore | 4.94 |
| **Total** | | **100.00** |

## II Performance

Exhibit 19 below discloses some statistics on performance of Al-Nukhba Fund over 20-month period extending from mid-1998 to February 2000. An obvious result is the upwards trend for the fund's NAV which appreciated from $99.59 in mid-1998 to $152.39 in January 2000.

Peak appreciation in NAV was recorded in late 1999 when value of the investment unit of the was $163.

**Exhibit 19**
**Al-Nukhba Fund – Performance Indicators**

| Month | 1998 | 1999 | 2000 |
|---|---|---|---|
| **January** | | 100.24 | 152.39 |
| **February** | | 100.12 | 150.81 |
| **March** | | 110.86 | |
| **April** | | 119.35 | |
| **May** | | 111.17 | |
| **June** | | 124.18 | |
| **July** | 99.59 | 126.59 | |
| **August** | 95.88 | 128.27 | |
| **September** | .94.52 | 133.51 | |
| **October** | 98.59 | 141 | |
| **November** | 99.94 | 151.00 | |
| **December** | 101.9 | 163 | |

Finally, the *Shari 'ah* screening for Al-Baraka equity funds are as follows:

a) Debt/asset ratio: borrowing at interest is non-allowed. But, a tolerable level of 30% or less is allowed by the *Shari 'ah* Board of Al –Baraka;

a) Interest/income received: companies receiving interest income should in principle be totally excluded. But, a tolerable level of 5% or less is endorsed by the *Shari 'ah* Board;

b) Purifying of returns: subject to a cleansing formula developed by the Group, investors are advised to deduct a certain percentage of their return every year to get return free of interest element.

c) Permissible activities: in the process of researching stocks of companies that undertake permissible business activities, Al-Baraka screened above 10,000 companies. The results percentages for non-compliance for various companies were: (a) prohibited business line – 22%; (b) excessive borrowing – 62%; (c) excessive interest income – 8%; (d) other exclusions – 3%; (e) total percentage of exclusion was 95%. Only 500 companies were found compliant with the set of criteria adopted.

### 3.3 Other Islamic Mutual Funds

There are, however, some other Islamic investment funds based and operate in the West. The most important of these is Amana Mutual Funds Trust based in the United States.

#### *3.3.1 Amana Mutual Funds Trust*

*Amana is* designed to meet the needs of various investors and in particular those of Muslim Community in the United States by investing in agreement with Islamic principles. It was launched in July 1984 as an open-end diversified management investment company.

The Trust is designed as a `series trust' that may offer several separate funds for investors. The Income Fund commenced operations on June 23, 1986. The Growth Fund began operations on February 3, 1994, *(Amana* Prospectus, August 23, 1996).

The primary objective of the Growth Fund is long-term capital growth, in agreement with *Shari 'ah* principles. The objectives of the Income Fund are current income and preservation of capital compliant to Islamic principles.

Investors receive financial report regarding investments, income and expenses of the two Funds every six months. The Funds may advertise or publish current yield and average annual total return.

The shares of each Fund have equal voting rights, and all shares are fully paid, non-assessable , transferable and with rights of redemption and are not subject to preemptive rights. Each Fund intends to distribute substantially all its net investment income and net realized capital gains.

Values of assets under management of each Fund are determined by using the price carried out by the composite tape of all U.S. exchanges after 4 p.m. New York time. Securities traded on a U.S. exchange are valued at the last sale price or, in the absence of any sale on that date, the closing bid price.

Each Fund pays the Adviser an advisory and administration fee of 0.95% annually of average daily net assets. The religious adviser, NAIT, is paid for consulting services an annual fee of 0.2% of the average daily net asset value of each Fund. The Funds impose no sales load on purchase or reinvested dividends. There are no redemption fees or exchange fees.

## I. Portfolio Diversification

On one hand, the policy of the Income Fund is to invest at least 80% of its assets in income-producing equity securities, such as dividend-paying common stocks. Some assets may be held as cash to cover short-term needs as redemption, (*Amana* Prospectus, August 1996). Including cash for short-term needs, the Income Fund may invest up to 20% of its assets in non-income producing securities for use in covered option writing to earn premium income.

On the other hand, and under normal circumstances, it is the policy of the Growth Fund to invest at least 80% of assets in common stocks that involve greater risk than some other investments such as investments in short-term bonds and money market instruments. The Fund selects investments primarily on the expectation of the increases in earnings and share price, and not current dividend-paying ability.

Both Funds are diversified, and do not invest more than 5% of total assets in the securities of any one issuer. The Fund will not invest more than 25% of its assets in any particular industry. However, each Fund may invest up to 10% of its assets in foreign securities not traded publicly in the U.S., but currently they limit such investments to 5%.

## II. Performance

Exhibits 20 and 21 overleaf uncover data on performance of the two Funds for several years since inception of each. It appeared that NAV of the Income Fund, the one set up first in June 1986, was growing at relatively moderate pace. Assets values rose from US$10.0 million in 1986 to US$12.92 million in 1996, i.e. an increase of 29.2% over a decade.

Net investment income, on the other hand, were around 30 to 40 percent throughout the ten years 1986 to 1996. Ratios of expenses to' average net assets dropped sharply from 2.07% in 1988 to 1.56% in 1995. Ratios of net investment income to average net assets fluctuated, rising up to 1992, then declining but recovering in 1995 and 1996. Portfolio turnover rate while rocketing in first three years from 1986 to 1989, started declining in 1990 to only 19% and was active again in 1996 to be around 25%, (see Exhibit 20).

# Exhibit 20
# *Amana* Income Fund - Selected Performance Data

| | 1996 | 1995 | 1994 | 1993 | 1992 | 1991 | 1990 | 1989 | 1988 | 5/31/87 |
|---|---|---|---|---|---|---|---|---|---|---|
| Net asset value at the beginning of period | $12.92 | $12.18 | $12.86 | $11.94 | $11.36 | $10.86 | $10.39 | $9.11 | $10.73 | $10.00 |
| Income from Investment Operations | | | | | | | | | | |
| Net Investment Income | 0.42 | 0.38 | . 0.30 | 0.32 | 0.32 | 0.39 | 0.38 | 0.38 | 0.30 | 0.28 |
| Net gains or losses on securities (both realized and unrealized) | 1.76 | . 0.80 | (0.36) | 0..92 | 0.58 | 0.46 | 0.53 | 1.29 | (1.65) | 1.24 |
| Total from investment operations " | 2.18 | 1.18 | (0.06) | 1.24 | 0.90 | 0.85 | 0.91 | 1.67 | (1.35) | 1.52 |
| Less distributions | | | | | | | | | | |
| Dividends (from net investment income) | (0.41) | (0.44) | (0.30) | (0.32) | (0.32) | (0.35) | (0.44) | (0.39) | (0.27) | (0.28) |
| Distributions (from capital gains) | (0.76) | 0.00 | (0.32) | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | (0.51) |
| Total distributions | (1.17) | (0.44) | (0.62) | (0.32) | (0.32) | (0.35) | (0.44) | (0.39) | (0.27) | (0.79) |
| Net asset value at end of period | $13.93 | $12.92 | $12.18 | $12.86 | $11.94 | $11.36 | $10.86 | $10.39 | $9.11 | $10.73 |
| Total return | 17.03% | 9.95% | (0.63)% | 10.26% | 7.88% | 8.11% | 8.85% | 18.86% | (12.68)% | 15.21% |
| Ratios/Supple-mental Data Net assets (S000). end of period | $12.64 | $10.708 | $10.432 | $9.398 | $6.913 | $5.868 | $4.760 | $3.645 | $3.559 | $3.189 |
| Ratio of expenses to average net assets (not annualized) | 1.57% | 1.56% | 1.58% | 1.58% | 1.58% | 1.66% | 1.76% | 1.88% | 2.07% | 1.81% |
| Ratio of net investment income to ave. net asset (not annualized) | 3.06% | 3.11% | 2.22% | 2.65% | 2.75% | 3.73% | 3.67% | 3.85% | 3.17% | 3.53% |
| Portfolio turnover rate | 24% | 29% | 21% | 29% | 19% | 29% | 19% | 71% | 66% | 55% |
| Average commission rate paid | | $0.0460 | | | | | | | | |

**Exhibit 21**
***Amana* Growth Fund — Selected Performance Data**

| | Year Ended May 31,1996 | Year Ended May 31,1995 | 2/3/1994 (inception) May 31,1994 |
|---|---|---|---|
| Net asset value at beginning of period | *$5.04* | *$4.69* | *$5.00* |
| Income from investment Operations | *(0.05)* | *(0.04)* | (0.01) |
| Net Investment income | | | |
| Net gains or losses on securities (both realized and unrealized) | 1.96 | *0.39* | *(0.39)* |
| Total from investment operations | *1.90* | *0.35* | (0.31) |
| Less distributor | | | |
| Dividends (from net investment income) | 0.00 | 0.00 | (0.01) |
| Distributions (from capital gains) | (0.08) | 0.00 | 0.00 |
| Total distributions | (0.08) | 0.00 | (0.01) |
| Net asset value at end of period | *$6.86* | *$5.04* | *$4.69* |
| Total return | *37.20%* | *7.46%* | *(6.20)%* |
| Ratios/supplemental data | | | |
| Net assets ($000), end of period | $4.151 | *$1.974* | *$962* |
| Ratio of expenses to average net assets (not annualized) | *1.94%* | *2.00#* | *0.62%* |
| Ratio of net investment income to average net assets (not annualized) | (0.79)% | (0.82)% | *(0.35)%* |
| Portfolio turnover rate (not annualized) | *22%* | *38%* | *6%* |
| Average commission rate paid | *$0.0596* | | |

### 3.3.2 Oasis Fund

The Fund was launched in May 1996 by the Flemings Investment Management. It is supervised. by *Shari 'ah* scholars.

The investment manager identifies a universe of 2600 stocks in MSCI Index. This figure was down to 1,000 (with the removal of un-Islamic or highly leveraged companies, then to 300 (after the application of five more investment screens), and finally, to between 100 and 150 eligible companies.

The Fund is also 'purified' through the deduction of interest received by companies within the portfolio, which Flemings estimates will cost its investors some 1% a year, (American Journal of Islamic Finance, October 1995).

The Fund is targeting high net worth investors among the UK estimated 2 million Muslims. The minimum initial subscription is US$ 50,000. The Fund will be an umbrella for sub-funds offering open-ended investment portfolio. The first sub-fund, known as "International Equity" will invest in a balanced portfolio of international equities drawn from MSCI Index, (Islamic Banker, July 1996).

Oasis is incorporated in Luxembourg and its shares are listed on the Luxembourg Stock Exchange. Initial subscriptions are accepted at the net asset value (NAV) per share plus an initial charge of up to 5%. Subscriptions and redemptions take place every week on Wednesday at prices based on NAV per share of the Fund that day.

Geographical distribution of the Fund's portfolio for three months of operations (June – August) of 1996 was mainly in the USA, Europe, Japan and a small percentage in emerging stock markets such as Hong Kong and Malaysia.

The cumulative performance after three months before purification stood at +3 percent and after purification at +2.9 percent. This compared with the MSCI World Index of 3%. Purification of the Fund by deduction of amounts representing interest received by companies in the portfolio is carried out on a weekly basis.

### *3.3.3 Al Madina Fund*

This is the first Islamic equity fund established in London, launched in September 1994 by a Western insurance company. The underwriters, Albany International, is part of the giant NY based Metropolitan Life Group (Met Life) which in the UK includes Albany Life Insurance Company Ltd., and Metropolitan Unit Trust Managers Ltd.

Investment contract is essentially *a mudaraba* contract. Advisers of the Fund were appointed under supervision of the Fund's three-man *Shari 'ah* Committee, which initially meets every two weeks and who will screen the contracts and activities of the Fund on an ongoing basis. However, promoters stress that they are committed to the objective of monitoring contents of the Fund continuously to ensure that companies invested in do not compromise the

*riba* conditions through either a merger or a compromise, (Islamic Banker, October 1994).

The Fund was created to meet the needs of the Muslims Community in the UK. 120 shares of FT 500 index have been disqualified for investment. The Fund is a medium-to-high risk investment.

**3.3.4 *Al Meezan Commodity Fund Ltd***

Al Meezan was launched in May 1996 by Kleinwort Benson Limited (KBL) and the Manama-based Islamic Investment Company, Bahrain. It is a joint-venture between this traditional and the other Islamic institution.

The Fund is an open-ended investment which will invest in physical commodities traded primarily on London Metal Exchange (LME). The Fund can trade in other commodities outside LME. The Fund will initially invest in industrial metals which carry potentially huge risk as prices may suddenly change.

The investment objective of the Fund is to achieve a target for its investors of 10 to 12% per annum over the medium term.

## CONCLUSION 4.1

**Concluding remarks:**

1. Mutual funds' industry has been flourishing over the 25-year period. They provide a wide range of markets for small savers and in terms of return, they outperformed other industries such as banking;

2. The majority of contemporary fiqh jurists disapprove transacting stocks of shareholding companies which occasionally establish usurious contracts though their prime business activities are permitted in *Shari 'ah* laws. This school of *fiqh* thought believes that trading in shares of such companies is not verifiable in the eyes of *fiqh* even for necessity because the concept of necessity is not applicable in this case.

3. Despite this strict *fiqh* view, Islamic equity funds have been established to deal in local, regional and global equities. Muslim jurists and Islamic bankers and economists have structured a set of rules to make working of these equity funds in compliance with Islamic teachings. These rules have been built upon the *fiqh* view that accepts dealing in shares of companies that frequently involve in usurious practices such as borrowing and lending on interest basis;

4. *Modus-operandi* has been developed to assist Islamic equity funds selecting shares of companies in accordance with the criteria designed and approved by *fiqh* jurists. The late development in this regard is construction of Dow Jones Islamic Market Index which gives parameters for selecting *Shari* 'ah-compatible stocks in the international markets;

5. An examination of some of the Islamic equity funds in existence has revealed that they apply the *fiqh* guidelines designed for this purpose;

6. What characterizes these funds is that, they have been addressing creditworthy individual investors while giving little attention to small and middle-class investors;

7. IEFs apply similar redemption procedure with no fee;

8. But IEFs differ in the rate and type of other fee as some of them impose low-rate and specific item fee while another group imposes a multiple-rate expense;

9. It is still not easy for investors to get adequate information about movements in prices of stocks which compose holdings of their IEFs. This is, however, attributed to lack of direct access to financial information services;

10. Adherence of IEFs to *Shari 'ah* guidelines exerts some sort of limitation on their works. Excluding shares of some companies (which. work in prohibited business activities, or having notoriously higher gearing ratio or maintaining a higher interest income to total income ratio) for religious consideration is a limitation on operation of IEFs;

11. IEFs use different standards in pricing their assets for the purpose of periodic evaluation and redemption. This may lead to unequal treatment of investment units upon redemption;

12. Fees taken by the manager is based on net asset value, since however, value of the assets under management continuously varies, the amount taken is ignored. This has *Shari 'ah* implication because the fund manager is an agent to unit holders and *ajr* (reward) must be known;

13. The share of Muslim countries in the portfolio of IEFs is pretty insignificant. This is due to lack of established stock markets in these countries. IEFs are required to deploy savings of the Muslim investors in their countries. This serves two purposes: first, economically benefiting Muslims themselves and, second, resolving *Shari'ah* issue that the majority of *fiqh* jurists argue that one of the strong reasons for prohibition of transacting shares of foreign companies is that they are under control and management of non-believers who never observe banning of *riba* or any practices prohibited by the *Shari 'ah;*

14. Transparency and disclosure as requisite for expansion of IEFs is not yet adequately accommodated. Rules for such things barely exist in Muslim countries;

15. Expansion of IEFS industry depends, among other things, on wide marketing of the concept and educating investors about its merits. Moreover, opening industry to free and fair competition along with good institutional set-up in Muslim countries would facilitate growth of this profession.

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